Supreme Court, U.S.
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IN THE

# SUPREME COURT OF THE UNITED STATES

October Term, 1978

No. 78-1696

DAYTON HYDRAULIC CO.,

*Petitioner,*

vs.

UNITED STATES OF AMERICA,

*Respondent.*

## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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May 14, 1979

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## INDEX

## CITATIONS



IN THE

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No. ____________

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DAYTON HYDRAULIC CO.,

*Petitioner*,

vs.

UNITED STATES OF AMERICA,

*Respondent*.

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## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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The Petitioner, Dayton Hydraulic Co., respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Sixth Circuit entered in this proceeding on February 16, 1979.

## OPINIONS BELOW

The judgment and opinion of the United States Court of Appeals for the Sixth Circuit, not yet reported, appears in the Appendix hereto. The judgment and opinion of the United States District Court for the Southern District of Ohio (Western Division), reported at 76-2 U.S.T.C. ¶ 9788, appears in the Appendix hereto.

## JURISDICTION

The judgment of the Court of Appeals for the Sixth Circuit was entered on February 16, 1979. This petition for certiorari was filed within ninety (90) days of that date. This Court's jurisdiction is invoked under 28 U.S.C. Section 1254 (1).

## QUESTIONS PRESENTED

1. Whether it is inequitable and/or erroneous to impose an assignment of income theory to a distribution of appreciated property to effectuate a redemption pursuant to 26 U.S.C. Section 303 when there is no intent to avoid a federal tax?

2. Whether the decision below conflicts in principle with the decision of *General Utilities & Operating Company* v. *Helvering*, 296 U.S. 200 (1935), as to the proper principle to be applied in the distribution by a corporation of appreciated stock to its shareholders?

3. Whether there was an assignment of income in this case?

## STATUTORY PROVISIONS INVOLVED

**United States Code, Title 26**

Section 303 (*Distributions in Redemption of Stock to Pay Death Taxes* (Appears in Appendix hereto)

Section 311 *Taxability of Corporation on Distribution On Distribution*

(a) *General Rule.* Except as provided in Subsections (b), (c), and (d) of this section and Section 453 (d), gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of —



(1) Its stock (or rights to acquire its stock), or

(2) property

* * *

## STATEMENT OF THE CASE

This case involves an appeal from a denial of a claim for a refund of federal income taxes in the amount of $120,793.38. Taxes in that amount were imposed on the Petitioner as a result of its distribution of certain appreciated property (stock in another corporation) as a redemption payment to an estate under the provisions of 26 U.S.C. Sec. 303 ("Distributions in Redemption of Stock to Pay Death Taxes). Despite the provisions of 26 U.S.C. Sec. 311, the Commissioner of Internal Revenue challenged that distribution and assessed federal income taxes as if the distributed stock was first sold and the proceeds distributed. In doing so, the Commissioner relied on a non-statutory exception to 26 U.S.C. Sec. 311, sometimes called assignment of income, and which exception has sometimes been used to attack certain transactions in which it was clear that there was an attempt to avoid all taxes in connection with the transaction. To more fully understand the case, it is necessary to present further background facts.

On May 25, 1965, Mr. Frank Hill Smith died (herein called "Decedent" or, if appropriate, "Estate"). At the time of his death the Decedent (and, obviously, his Estate) owned directly or indirectly all the stock in an Ohio corporation named Frank Hill Smith, Inc. (herein called "Hill Smith"). (The Petitioner, Dayton Hydraulic Co., is a successor in interest to Hill Smith).

On three (3) separate occasions, pursuant to 26 U.S.C. Sec. 303 (all citations herein are to be 26 U.S.C., commonly

known as the Internal Revenue Code), Hill Smith redeemed its shares which had been held by the Estate. These redemptions occurred on:

| | |
|---|---|
| August 20, 1965 | 12 shares |
| August 3, 1966 | 33 shares |
| January 5, 1968 | 42 shares |

One of the assets owned by Hill Smith during this time period was stock in The Van Cleve Hotel Company ("Van Cleve") which, in turn, owned a hotel in downtown Dayton, Ohio. In payment for the 42 Hill Smith shares, which the Estate redeemed on January 5, 1968, the Estate received from Hill Smith 2,468¼ shares of stock in Van Cleve.

The shareholders of Van Cleve had adopted, on October 27, 1967, a Plan of Liquidation and Dissolution in accordance with Section 337, Internal Revenue Code. Pursuant to that liquidation plan, a contract for the sale of its principal asset, the hotel, was executed and the sale was closed on December 29, 1967 and possession delivered on December 31, 1967. At the time of the redemption, no liquidating dividend had been distributed by Van Cleve to any of its shareholders.

At the time of the Section 303 redemption by Hill Smith – i.e., the distribution by Hill Smith of the 2,468¼ Van Cleve shares in exchange for the Hill Smith shares held by the Estate – Hill Smith had a tax basis for its 2,468¼ Van Cleve shares of Six Thousand Two Hundred Thirty-three and 47/100 Dollars ($6,233.47).

The stock in Hill Smith was included in the estate. The value of the Hill Smith stock necessarily included the value of the Van Cleve stock which was on the balance sheet of Hill Smith. This appreciated value of the Van Cleve stock was set in the estate at $432,088.44, and was,



therefore, included in the value of the gross estate for federal income tax purposes and on which the Estate paid approximately $1,000,000.00 in federal estate taxes.

Subsequent to the Hill Smith's redemption of its stock owned by the estate, Van Cleve liquidated and dissolved. The following liquidating distributions were made to the estate:

| | |
|---|---|
| January 12, 1968 | $370,237.50 |
| March 17, 1968 | 61,706.25 |
| November 7, 1967 | 13,057.04 |
| | $445,000.79 |

All liquidating distributions were made to the Estate. The Estate received a total of Four Hundred Forty-five Thousand and 79/100 Dollars ($445,000.79) in liquidating dividends from Van Cleve. It paid additional income taxes based on a reported gain of $12,912.35 which represented the difference between total distributions received and its basis in the Van Cleve stock as taken from the decedent's federal estate tax return.

## REASONS FOR GRANTING THE WRIT

**1. THE DECISION BELOW IS INEQUITABLE AND/OR ERRONEOUS INSOFAR AS IT IMPOSES AN ASSIGNMENT OF INCOME THEORY UPON A DISTRIBUTION OF APPRECIATED PROPERTY AS A PART OF AN INTERNAL REVENUE CODE SECTION 303 REDEMPTION WHEN**

**(A) THERE WAS NO INTENT TO AVOID A FEDERAL TAX, AND**

**(B) SECTION 303 ESSENTIALLY REQUIRES THE DISTRIBUTING CORPORATION TO DISTRIBUTE ITS MOST LIQUID ASSETS.**

Petitioner asserts that it is inequitable and/or erroneous for the courts below to uphold, in essence, the assessment by the Internal Revenue Service (herein sometimes called "Service" or "Commissioner") of an income tax upon the Petitioner when, in truth and fact, the Petitioner (a) followed exactly the prescription of the Internal Revenue Code, (b) did not avoid a federal tax — indeed, the Estate paid almost $1,000,000.00 in federal estate taxes — and (c) followed the intent and purpose of Section 303 by distributing its most liquid assets to the Estate which needed funds to satisfy its federal estate tax obligations.

Section 303 is designed to provide some protection to a Decedent who has substantial corporate stock (as defined in the statute) in his estate. Section 303 permits the holder of such corporate stock to redeem said stock and to receive from the corporation either cash or other property without the holder being required to have the re-



demption distribution treated as a dividend taxable as ordinary income. Instead, under Section 303, the distribution would be treated as return to capital or (long/short term) capital gain to the stockholder. In most cases, since the stock of the corporation would take as its basis the fair market value of the valuation date for estate tax purposes (See 26 U.S.C. Section 1014[1]) there would be little or no capital gain treatment upon the redemption (Tax Management Portfolio No. 91-3rd, "Corporate Stock Redemption — Section 303," Page A-2). Accordingly, the thrust of Section 303 is aimed primarily at the tax effect, if any, of the redemption and distribution upon the shareholder.

The thrust of Section 311, on the other hand, is aimed primarily at the tax effect, if any, of the distribution upon the corporation. At the time of the instant redemption and distribution by Hill Smith of the Van Cleve stock to the Estate (January 5, 1968), Section 311 provided (with certain statutory exceptions not here relevant) that the distributing corporation (i.e., Hill Smith) recognized no gain or loss when it distributed cash or other property (even if it is appreciated property) to a shareholder.

Appellant's argument is very simple: It was a corporation which held as a portfolio security 2,468¼ shares in Van Cleve. It distributed appreciated property (the 2,468¼ shares) to a shareholder in accordance with 26 U.S.C. Section 303 and 26 U.S.C. Section 311. Under Section 311, the distributing corporation does not recognize any gain.

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[1] This is, of course, prior to the change in this rule effected by Section 2005 of the Tax Reform Act of 1976, which provides for a carry-over basis by the Estate for any stock owned by the Decedent. As of the date of this petition, the carry-over basis rules have not yet been effectuated as of the date of this petition.

The decisions below plainly ignore the intents and purposes of Section 303. The clear thrust of Section 303 has been to promote corporate distribution of cash, quick assets and appreciated property to the estate of a deceased shareholder in order for the estate to generate the necessary cash to pay the applicable estate tax. Certainly, looking at the Section 303 redemption solely from the viewpoint of the corporation, there is no business purpose to complete the redemption, since the redemption usually has the effect of depleting its cash or other marketable assets. It is for that reason that the tax laws are structured so as to eliminate the otherwise harmful tax consequences to the corporation — even if the distribution is of appreciated property (See 26 U.S.C. Sec. 311 (d)).

It should be remembered that it is the estate of the shareholder of the corporation which triggers the Section 303 redemption; and, it is the Estate which needs the cash or other assets which are readily convertible to cash. The corporation should not have to have its financial resources depleted and, in addition, pay taxes on that depletion.

Let us look at the plight of a corporation which is covered by Section 303. It is controlled by the estate and mandated by the estate to distribute cash or assets readily convertible to cash. It is this liquidity which is important to the estate and to the redeeming corporation.

For example, the instant situation is no different than the following: Suppose Van Cleve held as a portfolio security 2,468¼ shares of stock in General Motors Corporation stock which it had held for many years and in which it had a tax basis of Ten Thousand Dollars ($10,000.00), but which had a fair market value of Five Hundred Thousand Dollars ($500,000.00). There is no question but that Hill Smith could, without incurring any tax liability, distribute that appreciated property to an Estate in a Section 303 redemption. This could be true even though the



Estate could convert the General Motors stock to cash the very next day. Indeed, that's the basic reason for Section 303 — to get cash, or property readily convertible to cash, into the hands of the Estate so that it can meet its estate tax obligations.

Given its underlying intent and purpose, Petitioner submits that it is inequitable and/or erroneous for the Commissioner to interpret Section 303 so as to impose a capital gains tax on Petitioner's distribution of Van Cleve stock and, at the same time, concede[2] that a similar distribution of General Motors stock would not be subject to an income tax.

If the underlying theory of the Government's case is — as it must be — that, although Petitioner's formal actions were correct, Petitioner's substantive actions should be pierced because somehow it was attempting to avoid a federal tax, then there is no basis for the Commissioner to concede the propriety of the distribution of General Motors stock in the hypothetical situation. In other words, in a substance over form position (the essence of the Commissioner's position), the purpose should be to attack the tax avoidance schemes. But that is not the case here. In the instant case, (a) a substantial federal tax was paid on the value and (b) from a purpose standpoint, the Petitioner should not be penalized because it was holding Van Cleve stock instead of General Motors stock. In either instance, the purpose of Petitioner would be to distribute its most liquid assets to the Estate so that the Estate could meet its federal estate tax liability. It is inequitable and/or erroneous for the Commissioner to say that a Van Cleve distribution is substantively wrong and at the same time

[2] "We agree with [Petitioner's] assertion that if it had transferred appreciated General Motors' stock, it would not have realized any gain." (Government's Trial Brief at Page 24).

concede that a General Motors distribution would be non-taxable at the corporate level. It is clear that the Van Cleve stock and the hypothetical General Motors stock are fungible assets as to their nature, purpose and unrealized appreciation. The same tax result should apply to both situations.

## 2. THE DECISION BELOW CONFLICTS IN PRINCIPLE WITH THE DECISION OF GENERAL UTILITIES & OPERATING COMPANY v. HELVERING, 296 U.S. 200 (1935), AS TO WHETHER A DISTRIBUTION TO ITS SHAREHOLDERS BY A CORPORATION OF APPRECIATED STOCK IN ANOTHER CORPORATION SHOULD RESULT IN A FEDERAL INCOME TAX TO THE DISTRIBUTING CORPORATION ON THE UNREALIZED APPRECIATION.

In 1935, the Supreme Court of the United States in *General Utilities & Operating Company* v. *Helvering,* 296 U.S. 200 (1935), ruled that a corporation recognizes no gain or loss on its distribution of appreciated stock to its shareholders. Indeed, there is no question but that the facts and the law in *General Utilities* make a clear and safe harbor for the instant distribution. There, the taxpayer held twenty thousand (20,000) shares of Islands Edison Company with a tax basis of Two Thousand Dollars ($2,000.00) and a fair market value of One Million One Hundred Twenty-two Thousand Five Hundred Dollars ($1,122,500.00). A third party wished to acquire the Islands Edison stock, but the corporation was hesitant because the corporation did not wish to recognize tax at the corporate level and subject the profit to further tax-



ation at the shareholder level upon any subsequent dividend distribution to its shareholders. Accordingly, the parties came to an agreement in which it was

> ". . . understood and agreed between them that [taxpayer corporation] would make distribution of the stock of Islands Edison Company to its [taxpayer corporation's] shareholders and that counsel would prepare a written agreement embodying the terms and conditions of the sale, agreement to be submitted for approval to the stockholders of the Islands Edison Company after this distribution of said stock by the [taxpayer corporation]" (296 U.S. at 202).

Following the distribution, "all holders of Islands Edison stock *sold* to Southern Cities Utilities Company [the stock] at $56.12½ per share." (296 U.S. at 203) (emphasis added).

Even though (1) there was more than one Million Dollars ($1,000,000.00) unrealized appreciation in the Islands Edison stock in the hands of the corporation, (2) the stock was distributed to the shareholders as a part of a grand plan to sell the stock without the corporation being required to recognize gain, and (3) the shareholders immediately converted the stock to cash, the Supreme Court concluded that "no taxable gain [resulted] from the distribution among its shareholders of the Islands Edison stock" (296 U.S. at 206).

Petitioner contends that its position in this case is squarely within this Court's decision in *General Utilities & Operating Co.* v. *Helvering, supra,* and that the Commissioner's position and the lower courts' opinions are contrary to this Court's long standing position.

### 3. THERE WAS NO ASSIGNMENT OF INCOME IN THIS CASE.

Petitioner urges that, under the unique facts of this case, there can be no assignment of income theory imposed upon Petitioner because no "income accrued" to Petitioner at the time of the distribution. Certainly, a shareholder does not realize income unless it is in its hands or under its unrestricted control. There is simply no basis in the instant fact situation that either of those factors were present at the time of the Petitioner's distribution of the Van Cleve stock. Petitioner had no cash in hand and certainly had no unrestricted control over the alleged "accrued income." For example, a shareholder does not recognize any income — even a liquidating dividend — until such time as the payment is authorized and paid out. That simple theory is all the Petitioner has asked the Commissioner to recognize in this case. There can be no assignment of income unless there is income.

## CONCLUSION

For these reasons, a writ of certiorari should issue to review the judgment and opinion of the United States Court of Appeals for the Sixth Circuit.

Respectfully submitted,

MERLE F. WILBERDING
Suite 600, IBM Building
Dayton, Ohio 45402

*Counsel for Petitioner*

May 14, 1979

No. 77-3062

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

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DAYTON HYDRAULIC CO.,
*Plaintiff-Appellant,*

v.

UNITED STATES OF AMERICA,
*Defendant-Appellee.*

APPEAL from the United States District Court for the Southern District of Ohio.

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Decided and Filed February 16, 1979

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Before: LIVELY and KEITH, Circuit Judges, and LAWRENCE,* Senior District Judge.

PER CURIAM. The only issue raised in this appeal from a judgment in favor of the Government is whether a corporation may escape capital gains tax on the increased value of shares of another corporation which it holds as an investment and which it distributes to its shareholders after the company issuing the shares has adopted and begun proceeding with a plan of liquidation and dissolution.

Dayton Hydraulic Company (Dayton) appeals from an adverse decision in a suit for refund of $120,793.28 in income taxes assessed against Dayton's predecessor, Frank

* Honorable Alexander A. Lawrence, Senior Judge, United States District Court for the Southern District of Georgia, sitting by designation.

Hill Smith, Inc. (Hill Smith), for the taxable year 1968. During 1967 and 1968, the pertinent times in this matter, Hill Smith was owned 88.6% by the Estate of Frank Hill Smith (the Estate) and 11% by another company which was wholly owned by the Estate. Thus, for all practical purposes, the Estate was the sole owner of Hill Smith.

During the relevant period, the Van Cleve Hotel Company (Van Cleve) owned property which it proposed to sell and thereupon to dissolve the corporation. Van Cleve was owned by 54 shareholders, with 2,468.25 (43.23%) of its shares being owned by Hill Smith. At a special meeting on October 27, 1967, Van Cleve's shareholders, by an affirmative vote of almost 95% of the outstanding shares, approved a plan of liquidation and dissolution of the Company. It appears that no subsequent meeting of the shareholders was called to discuss the proposal and no objections to such liquidation and dissolution were ever recorded subsequent to the meeting on October 27, 1967.

Hill Smith approved the resolution adopting the plan of liquidation and apparently would have resisted any attempt to rescind it. As recission of this resolution required the vote of two-thirds of the oustanding shares, Hill Smith's ownership of 43.23 percent of the shares outstanding could have effectively blocked any such attempted change in plan. And at all times subsequent to the October 27, 1967 meeting where the plan of liquidation and dissolution was approved, Hill Smith fully expected the liquidation to be completed. The proposed plan of liquidation and dissolution qualified under § 337 of the Internal Revenue Code of 1954, as amended.[1]

The liquidation and dissolution of Van Cleve proceeded

[1] Section 337 provides that if the proposed liquidation and distribution is completed within 12 months of the adoption of the plan, the transaction is tax-free to the distributing corporation.



in accordance with the plan. The sale of Van Cleve's assets was completed on December 29, 1967 and possession delivered to the purchaser on December 31, 1967. Liquidating distributions were paid on January 12, 1968, March 17, 1968, and November 7, 1968.

On January 5, 1968, after the sale on December 29, and before the first liquidating distribution on January 12, 1968, Hill Smith redeemed 42 shares of its stock from the Estate in exchange for its 2,468.25 shares of Van Cleve Stock.[2] Consequently, all liquidating distributions were made directly to the estate. Hill Smith did not report as income in 1968 any of the liquidating distributions paid by Van Cleve in respect to the shares transferred to the Estate. The Estate reported the distributions and treated them as income subject to capital gains treatment.[3]

The Commissioner determined that Hill Smith's distribution of the Van Cleve stock to the Estate constituted an anticipatory assignment of the liquidation proceeds Hill Smith was to receive from Van Cleve. Accordingly, the Commissioner determined that Hill Smith had additional capital gains income in 1968 equal to the difference between 1) the liquidating distributions constructively received by it but paid to the estate and 2) Hill Smith's basis in the Van Cleve stock. Hill Smith paid the resulting assessment of tax, and Dayton filed a claim for refund as successor to Hill Smith.

This suit was instituted when the claim for refund was denied. The district court, following this Court's en banc decision in *Jones* v. *United States*, 531 F.2d 1343 (6th Cir.

[2] The parties have stipulated that this exchange was made pursuant to Internal Revenue Code § 303 to facilitate payment of estate and inheritance taxes. Section 303 thus provided capital gains treatment of this exchange for estate tax purposes.

[3] See note 2, *supra*.

1976), agreed with the Commissioner and held that Hill Smith's distribution of the Van Cleve shares to the Estate constituted an impermissible anticipatory assignment of income.[4] We agree.

The crux of the test adopted in *Jones, supra,* entails viewing the "realities and substances" of events to determine whether, by the time the transfer of stock occurs, "the liquidation plan [is] practically certain to be completed despite the remote and hypothetical possibility of abandonment," 531 F.2d at 1346. On this test, the instant case presents a far stronger fact situation for the Government than was presented in *Jones, supra.* In that case, the plan of liquidation had been ratified and approved by the shareholders at the time of the transfer but the only other steps toward liquidation was the Board's approval of several liquidation arrangements and a letter informing stockholders that the first liquidation dividends would be exchanged for stock some 3½ months later. There was at least a "remote and hypothetical possibility" that the plan of liquidation would be abandoned. By contrast, the "hypothetical possibility of abandonment" was even more remote in the instant case. As in *Jones,* the plan of liquidation was in conformity with § 337 and the taxpayer had every expectation that the liquidation proceedings would be completed. But more important, Van Cleve's assets had already been sold and transferred at the time the Van Cleve stock was transferred to the Estate. Further, the liquidation proceeds were distributed a mere seven days after the transfer of shares.

Appellant argues that this case may be distinguished from *Jones, supra,* for several reasons. One of the principal arguments is that the anticipatory assignment rule

[4] The case was submitted to the district court without a jury upon an agreed statement of facts and memoranda.



should not apply where a corporation uses assets to redeem the stock of a deceased shareholder because the estate requires the redemption as a means of raising cash for the payment of estate taxes. 26 U.S.C. § 303(a). The argument here is that appellant only passively responded to demands imposed by the Estate and that it had neither positive business nor tax-avoidance purpose for redeeming the stock. Appellant also notes that the attempted double dipping present in the *Jones* case is absent from the instant case. Finally, appellant argues the inequities of permitting this forced redemption to deplete its marketable assets in order to satisfy the requirements of the estate of its deceased shareholder.

Although appellant's argument based on the equities of the case is not without appeal, the Court is of the opinion that it falls short of establishing a distinction which commands a legal result different from that dictated by *Jones, supra.* Rather, "we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributable to a different tree from that on which they grew," *Lucas* v. *Earl,* 281 U.S. 111, 115 (1930). Having concluded that this case is controlled by, and indistinguishable from, *Jones, supra,* the Court is of the opinion that appellant's transfer of stock to the estate constituted an impermissible anticipatory assignment of income.

Accordingly, the judgment of the district court is affirmed.

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 77-3062

DAYTON HYDRAULIC COMPANY,
Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,
Defendant-Appellee.

## JUDGMENT

(Filed February 16, 1979)

Before: LIVELY and KEITH, Circuit Judges, and LAWRENCE, Senior District Judge.

APPEAL from the United States District Court for the Southern District of Ohio.

THIS CAUSE came on to be heard on the record from the United States District Court for the Southern District of Ohio and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this case be and the same is hereby affirmed.

It is further ordered that Defendant-Appellee recover from Plaintiff-Appellant the costs on appeal, as itemized



below, and that execution therefor issue out of said District Court if necessary.

ENTERED BY ORDER OF THE COURT.

/s/ JOHN P. HEHMAN
Clerk
A True Copy.

Attest:
/s/ DOROTHY J. PHELAN
Deputy Clerk

Issued as Mandate: March 9, 1979.

COSTS: (To be awarded to appellee)

| | |
|---|---|
| Filing fee | $..... |
| Printing | $192.72 |
| Total | $192.72 |

[ATTACHMENTS OMITTED]

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF OHIO
WESTERN DIVISION

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Civil Action No. C-3-75-147

---

DAYTON HYDRAULIC CO.,
Successor Corporation to Frank Hill Smith, Inc.,
124 East Third Street, Dayton, Ohio 45402,
Plaintiff,

vs.

UNITED STATES OF AMERICA,
Defendant.

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## FINDINGS OF FACT, OPINION AND CONCLUSIONS OF LAW

(Filed October 22, 1976)

This matter is before the Court by agreement of counsel upon an agreed statement of facts and upon memoranda filed pursuant thereto. In accordance with Rule 52 of the Federal Rules of Civil Procedure, the Court does submit herewith its findings of fact, opinion and conclusions of law.

## I

## FINDINGS OF FACT

1. Plaintiff Dayton Hydraulic Company is the successor to a corporation known as Frank Hill Smith, Inc. During 1967 and 1968, the pertinent time references in this matter, Frank Hill Smith, Inc. was owned 88.6% by the Estate of Frank Hill Smith and 11.4% by Mad River Security Corporation. Mad River Security Corporation was wholly owned by the Estate of Frank Hill Smith. For all practical purposes, therefore, the Estate of Frank Hill Smith, deceased, was the sole shareholder of Frank Hill Smith, Inc.



2. During such pertinent time, an Ohio corporation known as Van Cleve Hotel Company owned property in downtown Dayton which it proposed to sell and thereupon to liquidate the corporation. At the time in question the Van Cleve Hotel Company was owned by 54 shareholders, owning a total of 5,709.625 shares. (Stipulation 12).[1]

3. A special meeting of the shareholders of the Van Cleve Hotel Company was held on October 27, 1967. A plan of liquidation and dissolution of the Company was approved at that time. 5,423.125 shares were represented either in person or by proxy. All voted in favor of the liquidation and dissolution. Included among those shares were the 2,468.25 owned by Frank Hill Smith, Inc. Following this meeting, no objections to such dissolution and liquidation were ever recorded; no subsequent meeting of the shareholders was called to discuss the proposal. A rescission of the resolution required the vote of two-thirds of the stock. The 43.23% owned by Frank Hill Smith, Inc. would have effectively blocked any change in plan.

At all times subsequent to the meeting of October 27, 1967, Frank Hill Smith, Inc. expected the liquidation to be completed. Such corporation approved of the liquidation and would have resisted any rescinding of the plan of liquidation (Stipulations 28, 29, 30, 31, 32). The pro-

[1] A total of the shares listed in Exhibit A attached to the stipulation of facts dated March 15, 1976, indicates a total of 4,906.25 shares, leaving a discrepancy of 800 shares. While no explanation for this discrepancy has been given, the Court will assume the validity of Stipulation No. 12.

posed plan of liquidation and dissolution qualifies under Internal Revenue Code § 337.

4. The liquidation and dissolution of the Van Cleve Hotel Company proceeded in accordance with the plan. On December 29, 1967, the sale of all assets to Christ Episcopal Church was completed and possession delivered on December 31, 1967. Liquidating distributions were paid on January 12, 1968, March 17, 1968, and November 7, 1969.

5. On January 5, 1968, after the sale on December 29, 1967, and before the first liquidating distribution on January 10, 1968, the Board of Directors of Frank Hill Smith, Inc. redeemed 42 shares of stock from the Estate of Frank Hill Smith and distributed to that estate all of the 2,468.25 shares of the Van Cleve Hotel Company. All liquidating distributions therefor were made to the Estate of Frank Hill Smith, deceased.

Frank Hill Smith, Inc. did not report as income in the year 1968 or 1969 any liquidating distributions paid by Van Cleve in respect to the shares transferred to the estate. The Estate of Frank Hill Smith reported the distributions and treated them as income subject to capital gain treatment. For purposes of computing the amount of capital gain treatment. For purposes of computing the amount of capital gain, the estate claimed a basis of $432,088.44. This figure represented a per share value of $10,287.82 consistent with previous redemptions of shares in Frank Hill Smith, Inc. on August 20, 1965, and August 3, 1966.

6. A subsequent assessment by the Internal Revenue Service of taxes for the year 1968 and interest was paid and a claim for refund filed. All procedural steps necessary to a determination by this Court have been taken by both sides and this matter is properly before the Court for determination.



## II

## OPINION

While the foregoing fact recitation is somewhat complex, the legal question presented to this Court is substantially simpler. The only determination necessary is whether or not the case of *Virginia Kelsy Jones* v. *United States of America*, 531 F.2d 1343 (6th Cir. en banc decided and filed February 23, 1976) is controlling. If it is, the plaintiff cannot prevail; if it is not, the provisions of 26 U.S.C. § 311 would appear to grant plaintiff the relief it seeks.

The *Jones* case involved the following set of circumstances: Virginia Kelsy Jones owned approximately 10% of the Buckeye Union Casualty Company. On February 15, 1965, the shareholders of the corporation approved a liquidation plan by an overwhelming majority. On June 15, 1965, the shareholders were informed that the first liquidating dividend would be paid in exchange for stock in October of 1965. On June 17, 1965, taxpayer Jones donated 4,250 shares of stock to various public charities. The liquidating distributions began in October of 1965 and were completed by January 14, 1966. The plan of liquidation qualified under § 337. The taxpayer claimed a charitable deduction for the donated stock. Internal Revenue Service permitted the charitable deduction but considered the transaction an "anticipatory assignment of liquidation proceedings" and assessed a long term capital gain tax, asserting that the taxpayer had also received income.

*Jones* presents a strikingly paralled fact situation. Neither taxpayer was a majority shareholder, although plaintiff herein was the largest single shareholder and approached majority control; both corporations had adopted a plan of liquidation which in fact was carried out; and in both instances taxpayer transferred shares of stock between the time of liquidation and the time of actual distribution.

Two circumstances appear to make this case stronger from the defendant's standpoint. First, the sale of assets, transfer of stock, and first liquidating distribution all occurred within a period of two weeks. In *Jones,* the period of approximately four months elapsed between the approval of liquidation, the transfer of stock and the first liquidating distribution. Second, Jones owned 10% of the outstanding stock and presumably could not have barred a recission of the liquidation and dissolution. Here, the taxpayer controlled 43% of the stock, sufficient to prevent a rescission of the dissolution.

The Court in *Jones* followed the view of the Eighth Circuit in *Hudspeth* v. *United States,* 471 F.2d 275, and the Second Circuit in *Kinsey* v. *Commissioner,* 477 F.2d 1058. Both *Hudspeth* and *Kinsey* dwelled on the likelihood that the liquidation would proceed. In *Hudspeth* the following statement is made:

> The liquidation had proceeded to such a point where we may infer that it was patently never taxpayer's intention that his donees should exercise any ownership in the viable corporation, but merely that they should participate in the proceeds of the liquidation. 471 F.2d at 279, cited 531 F.2d 1343, at p. 1345.

Likewise in *Kinsey* the following statement appears:

> Realistically considered in the light of all the circumstances, the transfer of the . . . stock to DePauw [University] was an anticipatory assignment of the liquidation proceeds. 447 F.2d at 1063, cited 531 F.2d 1343, at p. 1345.

The "realities and substance" test is likewise the basis for the *Jones* decision. The Court reasoned as follows:

> [1] The realities and substance of the events in this case indicate that the taxpayer expected the liquidation proceedings to be completed. [2] The liquidation was conducted in accordance with § 337 of the Internal Revenue Code of 1954 which requires a corporation to liquidate within one year from the adoption of a plan of liquidation in order for the corporation to be eligible for nonrecognition of any gains from the sale of assets. If the liquidation had not been completed, the corporation would have had to recognize a substantial taxable gain on the assets that were sold. . . .
>
> [3] Overwhelming shareholder vote (968,605 to 175) approving the liquidation plan indicates a practical certainty of a completion of the liquidation proceedings . . .
>
> *Jones, supra* at 1345.



If realities and substance is the test in this Circuit, it is clear that plaintiff must fail. Plaintiff has stipulated there was no intention of rescinding the liquidation plan, the liquidation vote was unanimous and at the time of transfer, the corporate assets of Van Cleve Hotel were all cash and in fact distributed in the first liquidation distribution approximately one week following the transfer.

Plaintiff's reliance upon 26 U.S.C. § 311 appears to be misplaced. Section 311 oriignated in the 1954 revision of the Internal Revenue Code. The Committee report on this section states: "Your Committee does not intend to change existing law with respect to attribution of income of shareholders to their corporation as exemplified, for example, in the case of *Commisisoner* v. *First State Bank of Stratford* [168 F.2d 1004, 5th Cir. 1948, cert. den. 335 U.S. 867]." S. Rep. 1622, 83rd Congress 2d Session, p. 247 (1954).

*First State Bank of Stratford* was concerned with the tax consequences of a distribution by a bank to its shareholders of certain notes that it had written off as worthless in ear-

lier years. Despite the writeoffs, the notes were thought at the time of distribution to be collectible in part. The Court held that the collections were income to the bank. The Court pointed out:

> "The notes as collected would have been income to the corporation and they were nonetheless the fruition of economic gain when collected by the assignees. It is the realization of income rather than the acquisition of the right to receive it that is the taxable event and there is no reason why the rule that income tax is not to be avoided by an anticipatory assignment of income shall not apply to dividends." 168 F.2d 1004, at p. 1007.

The law appears to be well settled that an owner of property cannot escape taxation on its income by transferring the property between the time the income accrues and the time it is paid. *United States* v. *Lynch,* 192 F.2d 178 (9th Cir.), *cert. den.* 343 U.S. 934.

Such assignment of income principles appear to apply to corporate distributions as broadly as they do to intrafamily gifts. *Siegel* v. *United States,* 464 F.2d 891 (9th Cir. 1972). *See also Lyon & Eustice, Assignment of Income:* Fruit & Tree as Irrigated by the P. G. Lakes case, 17 Tax L. Rev. 295, at pp. 396-399.

## III

## CONCLUSIONS OF LAW

A. This Court has jurisdiction in accordance with 28 U.S.C. § 1346(a).

B. Where a liquidation under Section 337 has commenced and proceeded to a point where rescission is un-



likely, an assignment of shares does not transfer tax liability, if any, from the assignor to the assignee. *Jones* v. *United States of America,* 531 F.2d 1343.

C. 26 U.S.C. § 311 did not change existing law and does not immunize corporations from the tax consequences of anticipatory assignment of income, whether in the guise of dividends, stock redemption, or otherwise. *Commissioner* v. *First State Bank of Stratford,* 168 F.2d 1004.

D. Plaintiff has failed to establish a right of recovery and its complaint herein should be and is hereby DISMISSED at its costs.

LET JUDGMENT ISSUE IN ACCORDANCE WITH THE FOREGOING.

/s/ CARL B. RUBIN
United States District Judge

William W. Milligan,
United States Attorney

By ..............................
Assistant U.S. Attorney

David J. Curtin,
Trial Attorney
Tax Division
Department of Justice
Washington, D.C. 20530
202/739-3649

ATTORNEYS FOR
DEFENDANT

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF OHIO
WESTERN DIVISION

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Civil Action No. C-3-75-147

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DAYTON HYDRAULIC CO.,
Successor Corporation to Frank Hill Smith, Inc.,
124 East Third Street, Dayton, Ohio 45402,
Plaintiff,

vs.

UNITED STATES OF AMERICA,
Defendant.

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## JUDGMENT

(Filed October 26, 1976)

This action came on for (hearing) before the Court, Honorable Carl B. Rubin, United States District Judge, presiding, and the issues having been duly (heard) and a decision having been duly rendered.

It is Ordered and Adjudged that the plaintiff has failed to establish a right of recovery and its complaint herein should be and is hereby DISMISSED at its costs.

That the plaintiff take nothing, that the complaint herein is hereby DISMISSED in its entirety.

That the defendants recover of plaintiff their costs of action.

Dated at Dayton, Ohio, this 26th day of October, 1976.

JOHN D. LYTER
Clerk of Court

By: /s/ BARBARA VINZANT
Deputy



## INTERNAL REVENUE CODE

### [¶ 17,392] CODE SEC. 303. DISTRIBUTIONS IN REDEMPTION OF STOCK TO PAY DEATH TAXES.

**(a) In general.**—A distribution of property to a shareholder by a corporation in redemption of part or all of the stock of such corporation which (for Federal estate tax purposes) is included in determining the gross estate of a decedent, to the extent that the amount of such distribution does not exceed the sum of —

(1) the estate, inheritance, legacy, and succession taxes (including any interest collected as a part of such taxes) imposed because of such decedent's death, and

(2) the amount of funeral and administration expenses allowable as deductions to the estate under section 2053 (or under section 2106 in the case of the estate of a decedent nonresident, not a citizen of the United States),

shall be treated as a distribution in full payment in exchange for the stock so redeemed.

**(b) Limitations on Application of Subsection (a).—**

**(1) Period for distribution.**—Subsection (a) shall apply only to amount distributed after the death of the decedent and—

(A) within the period of limitations provided in section 6501 (a) for the assessment of the Federal estate tax (determined without the application of any provision other than section 6501 (a)), or within 90 days after the expiration of such period, or

(B) if a petition for redetermination of a deficiency in such estate tax has been filed with the Tax Court

within the time prescribed in section 6213, at any time before the expiration of 60 days after the decision of the Tax Court becomes final.

**(2) Relationship of stock to decedent's estate.—**

(A) In general.—Subsection (a) shall apply to a distribution by a corporation only if the value (for Federal estate tax purposes) of all of the stock of such corporation which is included in determining the value of the decedent's gross estate is either—

(i) more than 35 percent of the value of the gross estate of such decedent, or

(ii) more than 50 percent of the taxable estate of such decedent.

(B) Special rule for stock of two or more corporations.—For purposes of the 35 percent and 50 percent requirements of subparagraph (A), stock of two or more corporations, with respect to each of which there is included in determining the value of the decedent's gross estate more than 75 percent in value of the outstanding stock, shall be treated as the stock of a single corporation. For the purpose of the 75 percent requirement of the preceding sentence, stock which, at the decedent's death, represents the surviving spouse's interest in property held by the decedent and the surviving spouse as community property shall be treated as having been included in determining the value of the decedent's gross estate.

**(c) Stock With Substituted Basis.—If—**

(1) a shareholder owns stock of a corporation (referred to in this subsection as "new stock") the basis of which is determined by reference to the basis of stock



of a corporation (referred to in this subsection as "old stock"),

(2) the old stock was included (for Federal estate tax purposes) in determining the gross estate of a decedent, and

(3) subsection (a) would apply to a distribution of property to such shareholder in redemption of the old stock, then, subject to the limitation specified in subsection (b) (1), subsection (a) shall apply in respect of a distribution in redemption of the new stock.

No. 78-1696



# In the Supreme Court of the United States

OCTOBER TERM, 1978

---

DAYTON HYDRAULIC CO., PETITIONER

*v.*

UNITED STATES OF AMERICA

---

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT*

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**MEMORANDUM FOR THE UNITED STATES IN OPPOSITION**

---

WADE H. MCCREE, JR.
*Solicitor General*
*Department of Justice*
*Washington, D.C. 20530*

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**MEMORANDUM FOR THE UNITED STATES IN OPPOSITION**

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The sole question presented in this federal income tax case is whether the decision below correctly held that petitioner, which owned stock in a corporation in the process of liquidating and dissolving, was required to recognize gain on the liquidating distributions where petitioner transferred its stock to another party after the liquidation was substantially complete and immediately prior to the distributions in liquidation.

The pertinent facts are as follows: Petitioner is the successor of another corporation, Frank Hill Smith, Inc. (Hill Smith). During 1967 and 1968, 88.6% of the stock of Hill Smith was owned by the estate of the late Frank Hill Smith. A third corporation, wholly owned by the estate, owned the rest of the Hill Smith stock (Pet. App. 2a).

Hill Smith owned 2,468.25 shares of the Van Cleve Hotel Company (Van Cleve). On October 27, 1967, Van Cleve's shareholders, by the affirmative vote of almost 95% of the outstanding shares, adopted a plan of complete liquidation and dissolution. No objections to the liquidation were recorded. Hill Smith, with 43% of the outstanding Van Cleve shares, could have blocked any rescission of the plan (Pet. App. 2a). On December 29, 1967, Van Cleve completed the sale of its assets, and two days later the purchaser took possession. Van Cleve paid liquidating distributions on January 12, 1968, March 17, 1968, and November 7, 1968 (Pet. App. 3a).

On January 5, 1968, shortly before it would have received the initial liquidating dividend, Hill Smith distributed all of its Van Cleve stock to the estate in redemption of a portion of the Hill Smith shares held by the estate. Seven days later, on January 12, 1968, Van Cleve distributed $370,237.50 to the estate as a liquidating dividend. By the end of 1968, Van Cleve had distributed liquidating dividends to the estate in the total amount of $445,000 (Pet. App. 3a; Pet. 5).

Hill Smith did not report any of the liquidating distributions as income. On audit, the Commissioner of Internal Revenue concluded that Hill Smith's distribution of the Van Cleve shares to the estate was an anticipatory assignment of the liquidation proceeds that Hill Smith was due to receive from Van Cleve. He therefore determined that the liquidating distributions constituted additional income to Hill Smith in 1968 to the extent they exceeded Hill Smith's basis in the Van Cleve stock (Pet. App. 3a).

In this refund suit brought by petitioner, as successor to Hill Smith, in the United States District Court for the Southern District of Ohio, the district court upheld the Commissioner's determination on the basis of the



assignment-of-income doctrine. It held that the substance of the transaction was petitioner's receipt of the Van Cleve liquidation proceeds in return for Van Cleve stock, followed by the transfer of such proceeds to the estate. It therefore concluded that Hill Smith was liable for the tax on the gain on the liquidation (Pet. App. 11a-15a). The court of appeals affirmed (Pet. App. 3a-5a).

1. The decision below correctly held that petitioner was required to recognize gain equal to the amount by which its share of the liquidation proceeds exceeded its basis in the Van Cleve stock. In *Jones* v. *United States*, 531 F. 2d 1343 (6th Cir. 1976) (en banc), the court below held that if a taxpayer transfers stock in a corporation about to be liquidated, when completion of the liquidation is a virtual certainty, the transaction is in substance an exchange of stock for a share of the liquidation proceeds, and the transfer of the liquidation proceeds by the taxpayer. In this respect, the decision is in accord with other courts of appeals that have held the transfer of stock in a liquidating corporation prior to the physical receipt of the liquidation proceeds does not shift the taxation of the gain from the transferor when the "realities and substance" of the transaction are that the liquidation was practically certain to be completed. *Kinsey* v. *Commissioner*, 477 F. 2d 1058, 1062 (2d Cir. 1973); *Hudspeth* v. *United States*, 471 F. 2d 275, 277 (8th Cir. 1972).

In accordance with this unform line of decisions, petitioner is taxable on the gain from the Van Cleve liquidation. When Hill Smith distributed its Van Cleve stock to the estate on January 5, 1968, the liquidation of Van Cleve was assured. The plan of liquidation had been adopted without dissent. Van Cleve already had sold its operating assets and held only cash and receivables. Only seven days later, on January 12, 1968, Van Cleve

distributed more than $370,000 to the estate. Thus, the reality of the transaction was not a transfer of stock in a viable enterprise but rather a shift of a matured right to a pro-rata share of the liquidation proceeds. Under the settled assignment-of-income principles, petitioner cannot deflect the tax on its gain from the liquidation to the estate.[1]

Petitioner argues (Pet. 8-10) that its transfer of Van Cleve stock was no different than a hypothetical transfer of General Motors or other similar publicly traded stock. The cases are not comparable. The ownership of stock in an ongoing corporation represents more than a right to a share of the proceeds of liquidation. To the contrary, a transfer of stock in such a corporation conveys substantial rights to participate in the profits of a going concern. There is accordingly no reason to apply assignment-of-income principles to a transfer of such stock.

2. *General Utilities & Operating Co.* v. *Helvering*, 296 U.S. 200 (1935), upon which petitioner relies (Pet. 10), is not to the contrary. That case held that a corporation that declares a dividend payable in appreciated property is not required to recognize gain upon the distribution of such property. Although the Commissioner argued that the distributing corporation was liable for the gain under assignment-of-income principles, he had not made that argument before the Board of Tax Appeals or in his petition for review of the Board's decision. Accordingly, this Court ruled that the assignment-of-income argument was not properly raised, and that the court of appeals should not have considered it (see 296 U.S. at 206).

[1]There was no realistic possibility that Van Cleve would not liquidate. The Van Cleve plan of liquidation was designed to obtain the benefits of Section 337 of the 1954 Code (Pet. App. 10a). Under that provision, a corporation that undergoes complete liquidation may avoid taxation of the gain on the sale of its assets if it distributes its assets in complete liquidation within the 12-month period following the adoption of the liquidation plan. Thus, if Van Cleve had not completed the liquidation, it would have had to recognize the gain from the sale of its assets.



The *General Utilities* holding was later codified as Section 311(a) of the 1954 Code. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 37 (1954). Section 311(a) provides that a corporation's distribution of property with respect to its stock does not create taxable gain to the distributing corporation.[2] But it is settled that this general rule does not apply to a case where the recipient of about-to-be distributed income deflects its receipt to a third party. Under such circumstances, assignment-of-income principles require that transferor to include the amount in its gross income. Indeed, the legislative history expressly states that, in enacting Section 311(a), Congress did "not intend to change existing law with respect to attribution of income of shareholders to their corporation as exemplified for example in the case of *Commissioner* v. *First State Bank of Stratford* * * * [168 F. 2d 1004 (5th Cir. 1948), cert. denied, 335 U.S. 867 (1948)]." S. Rep. No. 1622, 83d Cong., 2d Sess. 247 (1954). In *First State Bank of Stratford*, the court held that a bank's distribution to its shareholders of notes, which the bank previously had written off as worthless, was an assignment of income by the bank. The bank was therefore held taxable on the collections received by the shareholders. There is no doubt that neither the *General Utilities* decision nor Section 311(a) supersedes the assignment-of-

[2]In 1969 Congress enacted Section 311(d), which prospectively provided that a corporation recognizes gain when it uses appreciated property to redeem its stock. This amendment does not apply here because the year in question is 1968. See Section 905 of the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.

income doctrine. See *Williamson* v. *United States*, 292 F. 2d 524, 527-528 (Ct. Cl. 1961); Treasury Regulations on Income Tax, Section 1.311-1(a) (26 C.F.R.).

3. Finally, petitioner argues (Pet. 6-10) that the decision below is contrary to Section 303 of the 1954 Code. That statute provides capital gains treatment to shareholders upon the redemption of corporate stock which was included in a deceased shareholder's gross estate. Property received by a shareholder in a Section 303 redemption is treated as received in exchange for the redeemed stock, rather than as a dividend distribution. But Section 303 applies at the shareholder level. It has no bearing on the question whether a distribution is an assignment of income taxable to the distributing corporation.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
*Solicitor General*

JUNE 1979